[JOINT COMMITTEE PRINT]

DESCRIPTION OF EXPIRING TAX PROVISIONS

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

SENATE COMMITTEE ON FINANCE

ON MARCH 28, 1988

PREPARED BY THE STAFF

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INTRODUCTION

The Subcommittee on Taxation and Debt Management of the Senate Committee on Finance has scheduled a public hearing on March 28, 1988, on expired (1987) and expiring (1988) tax provisions. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a brief description of such tax provisions.[2]

The first part of the pamphlet is a summary listing of tax provisions that expired in 1987 and those scheduled to expire in 1988. The second part provides a brief description of the expired and expiring tax provisions including reference to recent legislative background and any current Administration or Senate legislative proposals relating to such provisions.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Expiring Tax Provisions* (JCS–8–88), March 24, 1988.

[2] The provisions described in this pamphlet include the section 861 rule for allocation and apportionment of research expenses (expired for taxable years beginning after August 1, 1987) and the tax credit for qualified research expenditures (scheduled to expire for expenditures after December 31, 1987). The Finance Committee press release announcing the March 28, 1988 hearing stated that these two provisions, which had been the subject of an earlier hearing (held April 3, 1987) before the Subcommittee, would not be addressed at the hearing scheduled for March 28, 1988.

For a more detailed description of these two provisions, see Joint Committee on Taxation, *Description of Proposals Relating to Research and Development Incentive Act of 1987 (S. 58) and Allocation of R&D Expenses to U.S. and Foreign Income (S. 716) (JCS–6–87), April 2, 1987.*

I. SUMMARY

Expired tax provisions (1987)

The following tax provisions expired at the end of 1987, unless otherwise indicated:

(1) 10-percent energy tax credit for biomass property;

(2) Exclusion for group legal services benefits, and tax exemption for an organization providing group legal services or indemnification against the cost of legal services as part of a qualified group legal services plan;

(3) Exclusion for employer-provided educational assistance benefits; and

(4) Section 861 rule for allocation and apportionment of research expenses (expired for taxable years beginning after August 1, 1987).

Expiring tax provisions (1988)

The following tax provisions are scheduled to expire at the end of 1988, unless otherwise indicated:

(1) 20-percent tax credit for qualified research expenditures;

(2) 10-percent energy tax credits for solar and geothermal property, and 15-percent credit for ocean thermal property;

(3) Targeted jobs tax credit;

(4) Tax exemption for qualified mortgage bonds and election to issue mortgage credit certificates;

(5) Certain rules relating to financially troubled thrift institutions (reorganizations, FSLIC assistance payments, and net operating losses);

(6) The ESOP exception to the excise tax on reversion of qualified plan assets; and

(7) Partial exemption for qualified taxicabs from the motor fuels excise taxes (after September 30, 1988).

II. DESCRIPTION OF PROVISIONS

A. Expired Provisions (1987)

1. Energy tax credit for biomass property (secs. 46(a)(2) and 46(b)(2)(A)(xi) of the Code)

Prior Law

Prior to January 1, 1988, a nonrefundable tax credit was allowed for certain investments in biomass property. The rate of the credit generally was equal to 10 percent for biomass property placed in service between October 1, 1978, and December 31, 1985, 15 percent for biomass property placed in service during 1986, and 10 percent for biomass property placed in service during 1987. For purposes of the credit, biomass property generally included property used to convert any organic substance (other than oil, natural gas, or coal or their products) into a synthetic liquid, gaseous, or solid fuel, or property that is used to burn the organic substance or the synthetic fuel (Code sec. 48(l)(15).

The production of gas from biomass is eligible for the section 29 credit for producing fuel from a nonconventional source. This credit is $3 per barrel of oil equivalent of the biomass-derived gas. Some recapture of the section 29 credit may occur because of the interaction with the expired energy tax credit for biomass property.

Legislative Background

The energy tax credit for biomass property was enacted in the Crude Oil Windfall Profit Tax Act of 1980, and was scheduled to expire on December 31, 1985. The Tax Reform Act of 1986 extended the credit for biomass property for two additional years, at 15 percent for 1986 and 10 percent for 1987.

2. Exclusion for employer-provided group legal services; tax exemption for qualified group legal services organizations (secs. 120 and 501(c)(20) of the Code)

Prior Law

Under prior law, amounts contributed by an employer to a qualified group legal services plan for an employee (or the employee's spouse or dependents) were excluded from the employee's gross income for income and employment tax purposes (sec. 120). The exclusion also applied to any services received by an employee (or the employee's spouse or dependents) or any amounts paid to an employee under such a plan as reimbursement for the cost of legal services for the employee (or the employee's spouse or dependents). In order to be a qualified plan under which employees were entitled to tax-free benefits, a group legal services plan was required to fulfill certain requirements. The exclusion for group legal services benefits expired for taxable years ending after December 31, 1987.

In addition, prior law provided tax-exempt status for an organization the exclusive function of which was to provide legal services or indemnification against the cost of legal services as part of a qualified group legal services plan (sec. 501(c)(20)). The tax exemption for such an organization expired for taxable years ending after December 31, 1987.

Section 120 required, among other things, that group legal service benefits provided under a qualified plan not discriminate in favor of highly compensated employees in certain respects. The Statement of Managers for the Tax Reform Act of 1986 indicated that the new nondiscrimination rules for employee benefits added by the 1986 Act (sec. 89) were to be applied to the exclusion for group legal service benefits in lieu of the prior-law rules if the exclusion was extended after 1987.

In 1984, Congress required that employers file information returns with respect to qualified group legal services plans (sec. 6039D). This requirement was intended to collect data with respect to the use of such plans so that Congress could evaluate the effectiveness of the exclusion.

Legislative Background

The section 120 exclusion and the section 501(c)(20) exemption were enacted initially on a temporary basis by the Tax Reform Act of 1976 (through 1981). They subsequently were extended, again on a temporary basis, by the Economic Recovery Act of 1981 (through 1984), Public Law 98–612 (through 1985), and the Tax Reform Act of 1986 (through 1987).

Proposal

S. 2119 (Senators Heinz, Moynihan, Durenberger, and Boren)

S. 2119 would reinstate the section 120 exclusion and the section 501(c)(20) exemption on a permanent basis, effective as of the termination date of the prior-law exclusion and exemption.

3. Exclusion for employer-provided educational assistance (sec. 127 of the Code)

Prior Law

General rules

Under present law, an employee must include in income and wages, for income and employment tax purposes, the value of educational assistance provided by an employer to an employee, unless the cost of such assistance qualifies (under sec. 162) as a deductible job-related expense of the employee. Amounts expended for education qualify as deductible job-related expenses if the education (1) maintains or improves skills required for the employee's current job, or (2) meets the express requirements of the individual's employer that are imposed as a condition of continued employment (Treas. Reg. sec. 1.162–5(a)). In the case of an employee, such expenses (if not reimbursed by the employer) are deductible only to the extent that, when aggregated with other miscellaneous itemized deductions, they exceed 2 percent of the taxpayer's adjusted gross income. No deduction is allowed for expenses incurred to qualify for a new trade or business (e.g., for law school tuition paid by a paralegal or accountant).

Under prior law, an employee's gross income and wages for income and employment tax purposes did not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts were paid or incurred pursuant to an educational assistance program that met certain requirements (sec. 127). This exclusion, which expired for taxable years beginning after December 31, 1987, was limited to $5,250 of educational assistance with respect to an individual during a calendar year.

Section 127 required, among other things, that educational assistance provided under such a program not discriminate in favor of highly compensated employees in certain respects. The Statement of Managers for the Tax Reform Act of 1986 indicated that if the section 127 exclusion for educational assistance were extended, the new nondiscrimination rules for employee benefits added by the 1986 Act (Code sec. 89) were to be applied to the exclusion in lieu of the prior-law rules.

In 1984, Congress required that employers file information returns with respect to educational assistance programs under section 127 (sec. 6039D). This requirement was intended to collect data with respect to the use of such programs so that Congress could evaluate the effectiveness of the exclusion.

Tuition reduction for graduate teaching assistants

Pursuant to section 127(c)(8) (prior to its expiration), the exclusion under section 117 relating to qualified tuition reductions ap-

plied to graduate-level courses in the case of graduate teaching or research assistants at colleges or universities. Under the section 117 rules, as amended by the Tax Reform Act of 1986, the amount of qualified tuition reduction provided to an employee of an educational institution is includible in gross income and wages to the extent the tuition reduction constitutes payment for teaching, research, or other services (sec. 117(c)). Any amount of qualified tuition reduction (up to the amount of tuition) in excess of such payment may qualify for exclusion pursuant to section 117(d).

No amount of tuition reduction for graduate-level courses is excludable under section 117(d) for taxable years beginning after December 31, 1987, because of the expiration of section 127.

Legislative Background

The section 127 exclusion first was established on a temporary basis by the Revenue Act of 1978 (through 1983). It subsequently was extended, again on a temporary basis, by Public Law 98-611 (through 1985) and by the Tax Reform Act of 1986 (through 1987). The extension of the section 117(d) exclusion for qualified tuition reduction to include graduate-level courses in the case of graduate teaching or research assistants was incorporated in section 127 by Public Law 98-611.

Proposal

S. 39 (Senators Moynihan, Heinz, Boren, Pryor, Matsunaga, Riegle, Mitchell, Durenberger, Danforth, Rockefeller, and others)

S. 39 would reinstate the section 127 exclusion on a permanent basis, effective as of the termination date of the prior-law exclusion.

4. Allocation and apportionment of research expenses (secs. 861(b), 862(b), and 863(b) of the Code)

Present Law [3]

In general

U.S. persons are taxable on their worldwide income, including their foreign income. A U.S. person that earns foreign income may incur foreign income tax. Subject to the applicable foreign tax credit limitations, such a person may credit foreign income taxes against its U.S. tax liability. The purpose of the foreign tax credit and the foreign tax credit limitations is to yield primary taxing jurisdiction over U.S. persons' foreign income to foreign governments, while retaining residual taxing jurisdiction over such income for the United States and ensuring that the full U.S. tax is paid on domestic income.

The foreign tax credit limitations operate by separating the taxpayer's total U.S. tax liability before tax credits ("pre-credit U.S. tax") into 2 categories: tax on U.S. source taxable income and tax on foreign source taxable income. Pre-credit U.S. tax on foreign source taxable income is further subdivided by limitation categories, or "baskets," of income. The pre-credit U.S. tax on any particular limitation category of foreign source income serves as the upper limit on credits for foreign taxes on that type of income.

Each foreign tax credit limitation equals total pre-credit U.S. tax times the ratio of the taxable income in that limitation category to worldwide taxable income. Foreign source taxable income equals foreign source gross income less the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any deductions which cannot definitely be allocated to some item or class of gross income (Code sec. 862(b)). Deductions allocated and apportioned to foreign source gross income must be further allocated or apportioned among the separate limitation categories of foreign source gross income in order to arrive at foreign source taxable income in any one limitation category. Finally, allocation and apportionment of deductions to U.S. source gross income determines the amount of taxpayer's U.S. source taxable income (sec. 861(b)).

The Code generally articulates only the broad principles of how expenses reduce U.S. and foreign source gross income, leaving the Treasury Department to provide detailed rules for the generally fact-specific task of allocating and apportioning expenses. The ap-

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[3] The provisions discussed in this section were treated more comprehensively in Part III of the April 2, 1987 pamphlet, prepared by the staff of the Joint Committee on Taxation for the Senate Committee on Finance, entitled *Description of Proposals Relating to Research and Development Incentive Act of 1987 (S. 58) and Allocation of R&D Expenses to U.S. and Foreign Income (S. 716)* (JCS-6-87).

plication of regulations to particular facts and circumstances, therefore, has a significant role in determining the proportions of taxpayers' worldwide taxable income that are treated as coming from foreign sources. These proportions control, in turn, the level of taxpayers' foreign tax credit limitations.

A taxpayer that has paid fewer foreign taxes in each limitation category than the foreign tax credit limitation with respect to that category credits all of its foreign income tax against pre-credit U.S. tax (such a taxpayer is said to have "excess limit" in each of its limitation categories). If the rules for allocating and apportioning deductions are then changed with the result that a greater proportion of the taxpayer's worldwide taxable income is deemed to come from foreign sources, the change cannot decrease the taxpayer's U.S. tax liability on its worldwide income. A taxpayer that has paid foreign taxes in excess of one or more of its foreign tax credit limitations (that is, a taxpayer with excess foreign tax credits) cannot currently use all of its foreign income taxes as credits. Upon a change of the allocation and apportionment rules, however, this taxpayer may experience a reduction in current U.S. tax liability of approximately 34 cents for every dollar of deduction that is converted from a foreign source deduction to a U.S. source deduction, thus converting a dollar of U.S. source taxable income to foreign source taxable income. Conversely, upon a change in the allocation rules that shifts deductions from U.S. to foreign income, a taxpayer with excess credits (or a taxpayer that previously had excess limit and finds itself, as a result of the rule change, with excess credits) may experience an increase in U.S. tax liability due to a reduction in the amount of its foreign income taxes that remain creditable.

Treasury Regulation sec. 1.861-8(e)(3)

Treasury Regulations promulgated in 1977 prescribe detailed rules for allocating and apportioning research and experimental expenses for purposes of computing the foreign tax credit limitation of a U.S. person, as well as for other purposes (Treas. Reg. sec. 1.861-8(e)(3)) ("the R&D regulation").[4]

The R&D regulation contemplates that taxpayers will sometimes undertake R&D solely to meet legal requirements. In some such cases, the R&D cannot reasonably be expected to generate income (beyond de minimis amounts) outside a single geographic source. If so, those deductible R&D expenses reduce gross income only from the geographic source that includes that jurisdiction.

After allocating deductions to meet legal requirements, the regulation generally allows 30 percent of deductible R&D expenses to reduce gross income from the source where over half of the taxpayer's total deductible R&D expenses are incurred. A taxpayer has the opportunity to apportion more than 30 percent of its R&D deduction exclusively to the source where R&D is performed if it can establish that a significantly higher percentage is warranted be-

[4] By its terms, the R&D regulation would also apply, for example, in determining the U.S. source taxable income of a foreign person, and the taxable income effectively connected with a U.S. trade or business conducted by a foreign person, insofar as those determinations are necessary under other "operative" Code sections. The operative section for the foreign tax credit limitation is section 904(a).

cause the R&D is reasonably expected to have a very limited or long-delayed application outside that geographic source.

After a taxpayer makes a place-of-performance apportionment, it must apportion the amount of its R&D deduction remaining, if any, on the basis of relative amounts of domestic and foreign sales receipts. Subject to certain limitations, a taxpayer may elect to apportion its R&D deduction under an optional gross income method instead of the sales method. Under a gross income method, a taxpayer generally apportions its R&D deduction (after allocation under the legal requirements test but not the place-of-performance test) on the basis of relative amounts of gross income from domestic and foreign sources. The basic limitation on the use of optional gross income methods is that the respective portions of a taxpayer's R&D deduction apportioned to U.S. and foreign source income using a gross income method may not be less than 50 percent of the respective portions that would be apportioned to each such income grouping using the sales apportionment method (with the latter's exclusive place-of-performance allocation, typically 30 percent).

Moratorium on application of the R&D regulation for foreign tax credit purposes

Effective for taxable years beginning after August 13, 1981, and on or before August 1, 1987, the R&D regulation was suspended for purposes of allocating and apportioning U.S.-incurred R&D expenses to items of foreign source and U.S. source gross income. This suspension was initially established by the Economic Recovery Tax Act of 1981 (ERTA), covering any taxpayer's first 2 taxable years beginning within 2 years after August 13, 1981. In the taxable years governed by this aspect of ERTA, all U.S.-incurred R&D expenses were allocated to U.S.-source income. This scheme was extended by the Deficit Reduction Act of 1984 (DEFRA) and the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) through taxable years beginning on or before August 1, 1986.

For taxable years beginning after August 1, 1986 and on or before August 1, 1987, the Tax Reform Act of 1986 (TRA) introduced a modified scheme under which 50 percent of such expenses (other than amounts incurred to meet certain legal requirements, and thus allocable to one geographical source) were allocated to U.S. source income, with the remainder allocated and apportioned either on the basis of sales or gross income. In contrast with the R&D regulation, the temporary rule of TRA (a) gave taxpayers using the gross sales method of apportionment an automatic place-of-performance allocation, for U.S.-incurred R&D, of 50 (rather than 30) percent; (b) allowed taxpayers using the gross income apportionment method to use the automatic place-of-performance rule; and (c) imposed no limit on the extent to which use of the gross income method could result in decreasing the amount of R&D expenses that would otherwise be allocated to foreign source income using the gross sales method.

Under the Code and regulations as presently written, the R&D regulation governs allocation and apportionment of U.S.-incurred R&D expenses (as well as foreign-incurred R&D expenses) in all taxable years beginning after August 1, 1987.

Legislative Background

At a hearing before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee on April 3, 1987, the Treasury Department testified in favor of a proposal that would have made permanent a modified version of the TRA rules for allocating R&D expenses. The modification would have increased to 67 percent the proportion of U.S.-incurred expenses for R&D (other than amounts allocated to one geographical source because of legal requirements) automatically allocated to U.S. source income. As under TRA, taxpayers using the gross income method of apportionment (as well as taxpayers using the gross sales method) could use the 67-percent automatic place-of-performance allocation, and allocation results achieved under the sales method were not to be a limitation on the use of more favorable results obtainable under the gross income method.

The proposal endorsed at the April 3 hearing was included in H.R. 3545, the Omnibus Budget Reconciliation Act of 1987 (OBRA) as passed by the House. The House-passed provision was also included in the October 1987 budget reconciliation submission of the Senate Finance Committee to the Senate Budget Committee.[5] The provision was not included, however, in the conference agreement on OBRA.

Proposal

Administration proposal

The President's fiscal year 1989 budget proposes to allow taxpayers to allocate, for taxable years beginning after August 1, 1987, at least 67 percent of expenses for R&D to U.S. source income. The details of the President's proposal generally follow the details of the provision passed by the House and approved by the Senate Finance Committee in October 1987.

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[5] This proposal had been introduced in the Senate on August 6, 1987, as S. 1617 (Senators Wallop, Baucus, Danforth, Moynihan, Chafee, Roth, Boren, Pryor, Heinz, Durenburger, Armstrong, Riegle, Rockefeller, and others).

B. Provisions Expiring in 1988

1. Tax credit for qualified research expenditures (sec. 41 of the Code)

Present Law

General rule

A 20-percent tax credit is allowed for qualified research expenditures incurred by a taxpayer in carrying on a trade or business (sec. 41). Except for certain university basic research payments, the credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of the taxpayer's yearly qualified research expenditures in the specified base period, which generally is the preceding three taxable years.

Eligible expenditures

Research expenditures eligible for the 20-percent incremental credit under present law consist of (1) "in-house" expenditures by the taxpayer for research wages and supplies used in research; (2) certain time-sharing costs for computer use in research; and (3) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf. Under the 1986 Act, a 20-percent tax credit also applies to the *excess* of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for university basic research *over* (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed base period, as adjusted for inflation. This modified university basic research credit was effective for taxable years beginning after 1986.

The amount of credit-eligible basic research expenditures to which the university basic research credit applies does not enter into the computation of the incremental credit. The remaining amount of credit-eligible basic research expenditures—i.e., the amount to which the university basic research credit does not apply—enters into the incremental credit computation (and in subsequent years enters into the base period amounts for purposes of computing the incremental credit).

Research definition

The 1986 Act provided statutory rules defining qualified research for purposes of the incremental credit. These rules target the credit to research undertaken to discover information that is technological in nature and that pertains to functional aspects of products. Also, the 1986 Act expressly excluded certain types of expenditures from eligibility for the credit, including post-production research

activities, duplication or adaptation costs, and surveys, studies, and certain other costs. The definitional modifications were effective for taxable years beginning after 1985.

Relation to deduction

The credit is available for incremental qualified research expenditures for the taxable year whether or not the taxpayer has elected under section 174 to deduct currently its research expenditures. The amount of any section 174 deduction to which the taxpayer is entitled is not reduced by the amount of any credit allowed for qualified research expenditures.

Computation of allowable credit

General rule.—As a general rule, the credit applies to the amount of qualified research expenditures for the current taxable year that exceeds the average of the yearly qualified research expenditures in the preceding three taxable years. The base period amount is not adjusted for inflation.

New businesses.—For a base period year during which it was not in existence, a new business is treated as having research expenditures of zero in such year for purposes of computing average annual research expenditures during the base period. However, the taxpayer may be deemed to have expenditures in such a base period year pursuant to the 50-percent limitation rule (described below).

50-percent limitation rule.—In computing the credit, the amount of base period research expenditures to be subtracted from current-year expenditures is treated as at least equal to 50 percent of the taxpayer's qualified research expenditures for the current year. This 50-percent limitation applies both in the case of existing businesses and in the case of newly organized businesses.

Aggregation rules.—To ensure that the credit will be allowed only for actual increases in research expenditures, special rules apply under which research expenditures of the taxpayer are aggregated with research expenditures of certain related persons for purposes of computing any allowable credit. These rules are intended to prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related persons.

Changes in business ownership.—Special rules apply for computing the credit when a business changes hands, under which qualified research expenditures for periods prior to the change of ownership generally are treated as transferred with the trade or business which gave rise to those expenditures. These rules are intended to facilitate an accurate computation of base period expenditures and the credit by attributing research expenditures to the appropriate taxpayer.

Trade or business limitations

The credit is available only for research expenditures paid or incurred in carrying on a trade or business of the taxpayer. With one exception relating to certain research joint ventures, the trade or business test for purposes of the credit is the same as for purposes of the business deduction provisions of section 162. Thus, for exam-

ple, the credit generally is not available to a limited partnership (or to any partners in such partnership, including a general partner that is an operating company) for partnership expenditures for outside or contract research intended to be transferred by the partnership to another (such as to the general partner) in return for license or royalty payments. Under the trade or business test, research expenditures of a taxpayer are eligible for the credit only if paid or incurred in a particular trade or business already being carried on by the taxpayer.

Other limitations and carryover

The 1986 Act made the research credit subject to the general business credit limitation (i.e., 75 percent of tax liability over $25,000), effective for taxable years beginning after 1985. Any excess amount of the general business credit can be carried back three years and carried forward 15 years, beginning with the earliest year.

In the case of an individual who owns an interest in an unincorporated trade or business, who is a beneficiary of a trust or estate, who is a partner in a partnership, or who is a shareholder in an S corporation, the amount of credit that can be used in a particular year also cannot exceed an amount (separately computed with respect to the person's interest in the trade or business or entity) equal to the amount of tax attributable to that portion of the person's taxable income that is allocable or apportionable to such interest. Any excess credit amount is eligible for the carryover rule described above.

Legislative Background

As enacted in the Economic Recovery Tax Act of 1981, the rate of the credit was 25 percent, and the credit was scheduled to expire after December 31, 1985. In the Tax Reform Act of 1986, the credit was extended for three years (i.e., for qualified research expenditures through December 31, 1988); also, the credit rate was reduced to 20 percent of the incremental research expenditure amount, effective for taxable years beginning after 1985.

Explanation of Proposals

Administration proposal

The President's budget proposal for fiscal year 1989 would establish a permanent tax credit for qualified research expenditures.

S. 58 (Senators Danforth, Baucus, Wallop, Boren, Durenberger, Mitchell, Riegle, Rockefeller, and others)

S. 58 would increase the research tax credit from 20 percent to 25 percent, and would make the credit permanent.[6]

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[6] For a more detailed explanation of present law and S. 58, see Joint Committee on Taxation, *Description of Proposals Relating to Research and Development Incentive Act of 1987 (S. 58) and Allocation of R&D Expenses to U.S. and Foreign Income (S. 716)* (JCS-6-87), April 2, 1987.

2. Business energy tax credits for solar, geothermal, and ocean thermal property (secs. 46(a)(2) and 46(b)(2)(A)(viii), (ix), and (x) of the Code)

Present Law

Under present law, a nonrefundable energy tax credit is allowed for certain investments in solar property, geothermal property, and ocean thermal property. In the case of solar property, the rate of the credit is 15 percent for 1986, 12 percent for 1987, and 10 percent for 1988. For geothermal property, the rate of the credit is 15 percent for 1986, and 10 percent for 1987 and 1988. The rate of the credit for ocean thermal property is 15 percent for 1986, 1987, and 1988. The energy tax credit for solar, geothermal, and ocean thermal property is not available for property placed in service after December 31, 1988.[7]

Legislative Background

The energy tax credit for solar, geothermal, and ocean thermal property was enacted in the Energy Tax Act of 1978, and was scheduled to expire on December 31, 1985. The Tax Reform Act of 1986 extended the energy tax credit for these types of property for three additional years (through 1988) at the rates specified above.

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[7] For definition of solar, geothermal, and ocean thermal property, see sections 48(l)(4), 48(l)(3)(A)(viii), and 48(l)(3)(A)(ix), respectively.

3. Targeted jobs tax credit (sec. 51 of the Code)

Present Law

Tax credit provisions

The targeted jobs tax credit is available on an elective basis for hiring individuals from nine targeted groups. The targeted groups are: (1) vocational rehabilitation referrals; (2) economically disadvantaged youths aged 18 through 24; (3) economically disadvantaged Vietnam-era veterans; (4) Supplemental Security Income (SSI) recipients; (5) general assistance recipients; (6) economically disadvantaged cooperative education students aged 16 through 19; (7) economically disadvantaged former convicts; (8) Aid to Families with Dependent Children (AFDC) recipients and Work Incentive (WIN) registrants; and (9) economically disadvantaged summer youth employees aged 16 or 17. Targeted group membership must be certified.

The credit generally is equal to 40 percent of the first $6,000 of qualified first-year wages paid to a member of a targeted group. Thus, the maximum credit generally is $2,400 per individual. With respect to economically disadvantaged summer youth employees, however, the credit is equal to 85 percent of up to $3,000 of wages, for a maximum credit of $2,550.

The credit is not available for wages paid to a targeted group member unless the individual either (1) is employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth employees), or (2) has completed at least 120 hours of work performed for the employer (20 hours in the case of economically disadvantaged summer youth employees). Also, the employer's deduction for wages must be reduced by the amount of the credit.

The credit is available with respect to targeted-group individuals who begin work for the employer before January 1, 1989.

Authorization of appropriations

Present law also authorizes appropriations for administrative and publicity expenses relating to the credit through September 30, 1988. These monies are to be used by the Internal Revenue Service (IRS) and Department of Labor to inform employers of the credit program.

Legislative Background

Extension of credit, authorization of appropriations

The targeted jobs tax credit was enacted in the Revenue Act of 1978 to replace an expiring credit for increased employment. As originally enacted, the targeted jobs credit was scheduled to terminate after 1981.

The availability of the credit was successively extended by the Economic Recovery Tax Act of 1981 (ERTA) for one year, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) for two years, and the Deficit Reduction Act of 1984 (the 1984 Act) for one year. For individuals who began work before 1986, the credit was available for wages paid during the first 24 months of employment. In addition, TEFRA authorized appropriations for the expenses of administering the system for certifying targeted group membership and of providing publicity to employers regarding the targeted jobs credit. The 1984 Act extended the authorization for appropriations for administrative and publicity expenses through fiscal year 1985.

The Tax Reform Act of 1986 extended the targeted jobs credit for three additional years (through 1988), with modifications. Under the 1986 Act, the modified credit is available for wages paid to targeted-group individuals who begin work for an employer after December 31, 1985 and before January 1, 1989. The 1986 Act extended the authorization for appropriations for administrative and publicity expenses through fiscal year 1988.

Modification of credit

ERTA, TEFRA, and the 1984 Act also modified the targeted group definitions and made several technical and administrative changes in the credit provisions.

The 1986 Act limited the extended credit in three respects: (1) a 25-percent credit for qualified wages paid in the second year of a targeted-group individual's employment was repealed; (2) a 50-percent credit for qualified first-year wages generally was reduced to a 40-percent credit (except that the credit allowed for wages of economically disadvantaged summer youth employees was retained at 85-percent of up to $3,000 of qualified first-year wages); and (3) no wages paid to a targeted-group member are taken into account for credit purposes unless the individual either (a) is employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth employees), or (b) has completed at least 120 hours of work performed for the employer (20 hours in the case of economically disadvantaged summar youth employees).

Under the Omnibus Budget Reconciliation Act of 1987, the credit is no longer available for wages paid to a targeted-group individual who performs the same or substantially similar services as an employee participating in, or affected by, a strike or lockout.

Proposal

S. 684 (Senator Heinz and others)

The bill would make the targeted jobs tax credit permanent. It would also extend the authorization for appropriations on an indefinite basis.

4. Qualified mortgage bonds and mortgage credit certificates (secs. 143 and 25 of the Code)

Present Law

Overview

Interest on bonds issued by a State or local government to finance governmental activities generally is tax-exempt (Code sec. 103). Interest on private activity bonds is taxable unless a specific exception is provided in the Internal Revenue Code. Private activity bonds are bonds that satisfy one or both of (1) a private business use and private payment test and (2) a private loan test. Private activity bonds qualifying for tax-exemption include exempt-facility bonds, small-issue bonds, qualified mortgage bonds and qualified veterans' mortgage bonds, qualified 501(c)(3) bonds, qualified student loan bonds, and qualified redevelopment bonds.

In general, the amount of private activity bonds that may be issued annually by any State (including local governments within the State) is limited to the greater of (1) $50 for every individual who is a resident of the State or (2) $150 million. Bonds subject to this limitation include qualified mortgage bonds and most other private activity bonds for which tax-exemption is permitted, and the private use portion (in excess of $15 million) of governmental issues.

Special rules applicable to qualified mortgage bonds

In general, qualified mortgage revenue bonds are bonds issued to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied homes located within the jurisdiction of the issuer of the bonds. All proceeds of an issue must be used to finance such loans.[8]

First-time homebuyer requirement

An issue is a qualified mortgage issue only if at least 95 percent of the net proceeds of the issue are used to finance residences for mortgagors who had no present ownership interest in their principal residences during the three-year period before the mortgage is executed. This first-time homebuyer requirement does not apply to mortgagors of residences located in targeted areas (as described below), mortgagors who receive qualified home improvement loans, or mortgagors who receive qualified rehabilitation loans.

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[8] For this purpose, the proceeds of an issue are determined net of costs of issuance permitted to be bond-financed and of amounts invested as part of a reasonably required reserve fund.

Income limitations

Qualified mortgage bond financing is available only to mortgagors whose family incomes do not exceed 115 percent of the higher of (1) the median family income for the area in which the residence is located, or (2) the Statewide median family income. Family income of mortgagors (as well as median family income) is to be determined by the Treasury Department after taking into account the regulations and procedures under section 8 of the United States Housing Act of 1937. Unlike the rules regarding qualified residential rental projects, no adjustments for family size are made under these income limitations.

In targeted areas, two-thirds of the mortgage financing provided with the proceeds of each issue must be provided to mortgagors who have family incomes not exceeding 140 percent of the higher of (1) the median family income for the area in which the residence is located, or (2) the Statewide median income. The remaining one-third of the mortgage financing of each issue may be used to provide mortgage loans without regard to income limitations.

A targeted area is defined as (1) a census tract in which 70 percent or more of the families have incomes that are 80 percent or less of the Statewide median family income, or (2) an area of chronic economic distress designated by the Secretary of the Treasury and the Secretary of Housing and Urban Development.

Purchase price limitations

The acquisition cost of a residence financed with qualified mortgage bonds may not exceed 90 percent (110 percent in targeted areas, as defined above) of the average area purchase price applicable to the residence. The determination of average area purchase prices is made separately (1) with respect to new residences and existing, previously occupied residences, and (2) to the extent provided in regulations, with respect to one-, two-, three-, and four-family residences.

Special rule for electing limited equity housing cooperatives

Certain "limited equity housing cooperatives", while constituting owner-occupied housing, may at the election of the cooperative be financed using the targeting rules for bond-financed qualified residential rental projects, provided the other compliance rules applicable to such rental property also are met.[9] Limited equity housing cooperatives are cooperative housing corporations (as defined under sec. 216(b)(1)) in which a person is entitled to occupy a dwelling unit by reason of ownership of stock in the cooperative. The election must be made when the bonds are issued, and once made is irrevocable. If no election is made, a limited equity housing cooperative is eligible for qualified mortgage bond financing on the same

[9] To qualify for financing under the targeting and compliance rules for qualified residential rental projects, (1) the cost of any stock in the cooperative must not exceed the amount paid for the stock by the original stockholder (as adjusted for cost-of-living increases), increased by amounts paid for improvements on the stockholder's house or apartment and certain other payments attributable to the stockholder, and (2) the assets of the cooperative in excess of the combined transfer values of outstanding stock in the cooperative (and reduced by any liabilities) must be used only for public or charitable purposes or directly to benefit the cooperative and may not be used directly to benefit any stockholder.

basis as other owner-occupied housing. Such financing is subject to all the limitations applicable to qualified mortgage bonds (including the first-time homebuyer and purchase price limitations).

Change in use rules

As with other private activity bonds, interest on loans financed with qualified mortgage bonds is nondeductible if a "change in use" occurs (sec. 150(b)). For qualified-mortgage bond-financed residences, such a change in use occurs if the residence is not the principal residence of one or all of the mortgagors for a period of at least one year. Interest is again deductible following a prohibited change in use if the residence again becomes the mortgagor's principal residence.

Mortgage credit certificates

Qualified governmental units may elect to exchange qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs) (sec. 25). MCCs entitle homebuyers to nonrefundable income tax credits for a specified percentage of interest paid on mortgage loans on their principal residence. Once issued, an MCC remains in effect as long as the residence being financed continues to be the certificate-recipient's principal residence. MCCs are generally subject to the same eligibility and targeted area requirements as qualified mortgage bonds.

Each MCC must represent a credit for at least 10 percent (but not more than 50 percent) of interest on qualifying mortgage indebtedness. The actual dollar amount of an MCC depends on the amount of qualifying interest paid during any particular year and the applicable certificate credit percentage. If the credit percentage exceeds 20 percent, however, the dollar amount of the credit received by the taxpayer for any year may not exceed $2,000.

The aggregate amount of MCCs distributed by an electing issuer may not exceed 25 percent of the volume of qualified mortage bond authority exchanged by the State or local government for authority to issue MCCs. For example, a State that is authorized to issue $200 million of qualified mortgage bonds and that elects to exchange $100 million of that bond authority can distribute an aggregate amount of MCCs equal to $25 million.

Termination

Authority to issue qualified mortgage bonds and the election to trade-in bond volume authority to issue MCCs is scheduled to expire after December 31, 1988.[10]

Proposal

S. 1522 (Senators Riegle, Durenberger, Mitchell, Daschle, and others)

S. 1522 would extend the termination date for the issuance of qualified mortgage bonds for four years, to December 31, 1992. In

[10] A proposed technical amendment to section 25(h) changes the termination date from 1987 to the intended 1988 date.

addition, the bill would extend through 1992 the election to issue MCCs in lieu of qualified mortgage bonds.

5. Financially troubled thrift institutions: reorganizations, NOLs, and FSLIC assistance payments (secs. 368(a)(3)(D), 382(l)(F), and 597 of the Code)

Present Law

Continuity of interest requirement

In order for the acquisition of a financially troubled thrift institution to qualify as a tax-free reorganization, the acquisition must satisfy the judically-created "continuity of interest" requirement. The continuity of interest doctrine generally requires that the shareholders of an acquired corporation maintain a meaningful ownership interest in the acquiring corporation in order for the transaction to qualify as a tax-free "reorganization" within the meaning of section 368(a).

In the case of mutually-owned organizations, such as many thrift institutions, there is considerable uncertainty under what circumstances the continuity of interest requirement is met.

Under special rules adopted in the Economic Recovery Tax Act of 1981 (the "1981 Act"), the continuity of interest requirement need not be satisfied in the case of a merger involving thrift institutions provided the following three requirements are met (sec. 368(a)(3)(D)). First, the acquired institution must be one to which section 593 applies, namely a savings and loan association, a cooperative bank, or a mutual savings bank. Second, the Federal Savings and Loan Insurance Corporation (FSLIC) or the Federal Home Loan Bank Board (FHLBB) (or if neither has jurisdiction, an equivalent State authority) must certify that the thrift institution in insolvent, that it cannot meet its obligations currently, or that it will be unable to meet is obligations in the immediate future. Third, substantially of of the liabilities of the transferor institution (including deposits) must become liabilities of the transferee. Moreover, if these conditions are satisfied, the acquired institution need not receive or distribute stock or securities of the acquiring corporation of the transaction in order for the transactions to qualify as a tax-free reorganization under section 368(a)(1)(D).

Net operating loss carryovers

Under the rules providing limitations on net operating loss carryovers before the 1986 Act in the case of reorganizations (sec. 382(b)), the net operating loss carryovers of a corporation were reduced if the shareholders of the corporation with the net operating loss carryover did not own at least 20 percent of the stock in the corporation surviving the reorganization.

The 1981 Act also provided that, for purposes of applying the loss limitation provisions, deposits in the acquired corporation that become deposits in the surviving corporation are treated as stock of

both corporations. The 1986 Act provided a special transitional rule which continued rules similar to the pre-1986 rules for financially troubled thrift institutions through 1988 (sec. 382(l)(F).

FSLIC assistance payments contributions to savings and loan associations

Generally, amounts received as insurance are includible in income or otherwise reduce any of the insured loss. Contributions to capital are excluded from the income of the recipient corporation (sec. 118). However, in the case of contributions to capital by nonshareholders, the basis of property acquired with the contribution normally must be reduced by such contributions (sec. 362(c)).

The 1981 Act provided that financially troubled savings and loan associations may exclude contributions from the FSLIC under its financial assistance program from income and need not reduce their basis for such contributions (sec. 597(b)). The provision does not apply to comparable contributions by the Federal Deposit Insurance Corporation (FDIC) to banks, including savings banks and cooperative banks.

Termination

Under present law, the above-mentioned special rules for financially troubled thrift institutions are scheduled to expire after December 31, 1988.

Legislative Background

The Economic Recovery Tax Act of 1981 provided special rules for reorganizations of financially troubled thrift institutions (described above). The Tax Reform Act of 1986 provided that the special rules terminate at the end of 1988.

6. Application of excise tax on reversion of qualified plan assets to ESOPs (sec. 4980(c)(3) of the Code)

Present Law

In general, prior to the satisfaction of all liabilities with respect to employees and their beneficiaries, the assets held under a qualified plan may not be used for, or diverted to, purposes other than the exclusive benefit of employees. However, if assets in excess of liabilities for benefits remain in a defined benefit pension plan upon plan termination as a result of actuarial error, then those assets may be paid to the employer as a reversion.

Under present law, employer reversions of plan assets are (1) includible in the gross income of the employer, and (2) subject to a 10-percent nondeductible excise tax payable by the employer. A reversion is not includible in gross income and is not subject to the excise tax to the extent the reversion is transferred to an employee stock ownership plan (ESOP) and certain requirements are satisfied.

A transfer of a reversion to an ESOP qualifies for the ESOP exception only if: (1) the amounts transferred to the ESOP are used within 90 days after the transfer to acquire employer securities or to repay loans used to acquire employer securities, (2) certain allocation rules are satisfied, (3) the securities acquired with the amounts transferred are held in the plan until distribution to plan participants, and (4) at least half of the participants in the plan from which the assets are transferred are participants in the ESOP.

The ESOP exception applies to amounts transferred (1) after March 31, 1985, and before January 1, 1989, or (2) after December 31, 1988, pursuant to a plan termination that occurs after March 31, 1985, and before January 1, 1989.

Legislative Background

The excise tax on reversions of assets from qualified plans (and the ESOP exception to the reversion tax and income inclusion rule) were added by the Tax Reform Act of 1986. Certain clarifying changes to the requirements for the ESOP exception were included in technical corrections to the 1986 Act approved by the House in the Omnibus Budget Reconciliation Act of 1987 and by the Senate Finance Committee in 1987 (but which have not yet been enacted).

7. Fuels tax exemption for certain taxicabs (sec. 6427(e)(3) of the Code)

Present Law

A 4-cents-per-gallon partial exemption from the motor fuels excise tax is provided through September 30, 1988, for fuels used in qualifying taxicabs. The excise taxes from which the exemption applies are the 9.1-cents-per-gallon taxes on gasoline (sec. 4081) and special motor fuels (sec. 4041) and the 15.1-cents-per-gallon tax on diesel fuel (secs. 4041 and 4091). The exemption is realized through a credit or refund (without interest). Qualifying taxicabs must meet certain group-ride requirements and fuel economy standards.

Legislative Background

This provision was enacted initially in the Energy Tax Act of 1978, and the partial exemption has been extended several times since then, most recently for three years (through September 30, 1988) in the Tax Reform Act of 1986.

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